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In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 73-1889

ESTATE OF LEONARD E. WHITLOCK, DECEASED, ET AL.

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. A A1-A46) is reported at 59 T.C. 490. The opinion of the court of appeals (Pet. App. B A47-A56) is reported at 494 F.2d 1297.

JURISDICTION

The judgment of the court of appeals (Pet. App. C A57-A58) was entered on April 22, 1974, and its order denying petitioners' petition for rehearing was entered on May 22, 1974 (Pet. App. D A59-A60). The petition for a writ of certiorari was filed on June 18, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether Section 951(a)(1)(B) of the Internal Revenue Code of 1954, which requires United States shareholders of a controlled foreign corporation to include in income their share of the corporation's "increase in earnings invested in United States property," is constitutional.

2. Whether United States shareholders of a controlled foreign corporation, who are required by Section 551 of the Code to include in income their share of their corporation's undistributed foreign personal holding company income, are also subject to tax under Section 951(a)(1)(B) on their share of the corporation's increase in its investment in United States property which is made from earnings of prior years.

3. Whether the amount of a controlled foreign corporation's increase in earnings invested in United States property under Section 956(a)(2) includes all of its earnings and profits to the extent so invested and is not limited to earnings accumulated after December 31, 1962.

4. Whether petitioners' 1963 income tax return did not disclose the omission of their controlled foreign corporation's increase in earnings invested in United States property in a manner adequate to apprise the Commissioner of the nature and amount of the item within the meaning of Section 6501(e)(1)(A)(ii), so that the six-year statute of limitations was applicable to an assessment for that year.

STATUTES AND REGULATIONS INVOLVED

The pertinent portions of Sections 316, 551, 951, 952, 954, 956, 957 and 6501 of the Internal Revenue Code of 1954 (26 U.S.C.) and Section 1.951-3 of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) are set forth in the Appendix, *infra*, pp. 16-30.

STATEMENT

During the years 1963-1967, petitioner Georgia M. Whitlock and her late husband, Leonard E. Whitlock, both of whom were United States citizens and residents, owned all of the stock of Whitlock Oil Services, Inc. ("Oil Services"), a Panamanian corporation which was both a "controlled foreign corporation" within the meaning of Section 957(a) of the Code for the entire period in question, and a "foreign personal holding company" as defined by Section 552 (a) of the Code for the years 1964 through 1967 (Pet. App. B A48-A49).

For each year in which it was a foreign personal holding company, Oil Services had "undistributed foreign personal holding company income" taxable in stipulated amounts to petitioners under Section 551 of the Code (Pet. App. A A7). For each of the years 1963 through 1967, Oil Services also had increased its investments in "United States property" as follows (Pet. App. A A4-A5):

Year	Total Investment in "United States property"	Increase for Year in Investment in Such Property
1963	$ 13,653.00	$ 13,653.00
1964	41,307.02	27,654.02
1965	226,034.75	184,727.73
1966	228,034.75	2,000.00
1967	453,216.08	225,181.33

At all pertinent times, Oil Services' retained earnings and profits, most of which were accumulated prior to 1963, exceeded its aggregate investment in "United States property" (Pet. App. A A6).

On audit, the Commissioner determined that these increases in investment in "United States property" were taxable to petitioners under Section 951(a)(1)(B) of the Code, which taxes such increases in investment in United States property to the United States shareholders of a "controlled foreign corporation," as that term is defined in Section 957(a) of the Code. The Tax Court unanimously upheld the constitutionality of the controlled foreign corporation provisions. It also rejected petitioners' contention that the deficiency for 1963 was barred under the general three-year limitations period of Section 6501(a) of the Code (Pet. App. A A28-A38). However, over the dissent of three judges (Pet. App. A A38-A46), the Tax Court concluded that because Oil Services was a foreign personal holding company for the years after 1963, Section 951(d) of the Code precluded the inclusion of its "increase in earnings invested in United States property" in petitioners' gross income after 1963, during which Oil Services

was a foreign personal holding company, and that the contrary provisions of Section 1.951-3 of the Treasury Regulations on Income Tax were invalid (Pet. App. A A1-A27).[1]

On cross appeals, the court of appeals rejected all of petitioners' contentions and sustained respondent's determination for all of the years in question (Pet. App. B A47-A58).

ARGUMENT

1. The courts below correctly upheld the constitutionality of Section 951(a)(1)(B) of the Code. The provisions of Section 951 through 964 of the Code were enacted in 1962[2] in order to limit the tax deferral privilege previously enjoyed by United States taxpayers with respect to the earnings of closely held foreign corporations and wholly owned foreign subsidiaries. See S. Rep. No. 1881, 87th Cong., 2d Sess., pp. 78-94. Under these provisions, United States shareholders of a "controlled foreign corporation" are subject to tax, under Section 951(a)(1)(A)(i), on certain types of current income of the corporation (referred to as "subpart F income") whether or not that income is distributed to them. Income derived by such corporations from investments in, and reinvested in, certain less developed countries is ex-

[1] The court thus did not reach petitioners' further contention that the statutory provisions should be construed to apply only to the investment of post-1962 earnings and profits (Pet. App. A A28).

[2] Revenue Act of 1962, Sec. 12, 76 Stat. 1006.

cluded from taxable Subpart F income. As a result, the statute (Section 951(a)(1)(A)(ii)) taxes the United States shareholders on these previously excluded amounts when they are withdrawn from investment in less developed countries. Moreover, Section 951(a)(1)(B) taxes such shareholders on the corporation's investment of previously untaxed earnings in various types of "United States property" as defined in Section 956(b). This element was included in the Subpart F tax base in order to ensure that such "earnings are not indirectly brought back to the United States in a manner which avoids the U.S. tax." S. Rep. No. 1881, *supra*, p. 80. See also *id.* at p. 88.

It is undisputed that Oil Services is a "controlled foreign corporation" [3] and that it had "increases in earnings invested in United States property" within the meaning of the statute. Petitioners contend (Pet. 19-20), however, that this statutory scheme under which foreign corporate earnings may be taxed to the controlling shareholders, even though not formally distributed as dividends, violates the due process clause of the Fifth Amendment and the apportionment of direct taxes clause of Article I, Section 9

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[3] Section 957(a) defines the term "controlled foreign corporation" as any foreign corporation more than 50 percent of the stock of which is owned by "United States shareholders," a term which, in turn, is defined under Sections 951(b), 957(d) and 7701(a)(30) to include any domestic corporation, partnership or trust and any United States citizen or resident who owns 10 per cent or more of the combined voting power of such a foreign corporation.

(Pet. 19). Virtually identical contentions were recently dismissed by the Second Circuit as "border-[ing] on the frivolous." *Garlock, Inc.* v. *Commissioner*, 489 F.2d 197, 202, certiorari denied, May 28, 1974, No. 73-1374.

There is no constitutional distinction between taxing the earnings of a partnership to the partners, whether or not distributed (*Heiner* v. *Mellon*, 304 U.S. 271, 280-281; *United States* v. *Basye*, 410 U.S. 441, 453-454), and taxing corporate income to stockholders of a controlled foreign corporation or foreign personal holding company. *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282, 288.[4] See also *Moline Properties* v. *Commissioner*, 319 U.S. 436, 439. Decisions of this Court have long established that where income

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[4] In *Helvering* v. *Nat. Grocery Co., supra*, the Court held constitutional the imposition of a surcharge on income of a corporation availed of for the purpose of preventing a surtax on its shareholders. The Court stated (304 U.S. at 288):

> If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxable to the partners individually, although these had been retained by the partnership undistributed. * * * Kohl, the sole owner of the business, could not by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits.

Significantly, the Court cited with approval the personal holding company and accumulated earnings tax provisions which similarly tax shareholders for undistributed corporate earnings. See also *Eder* v. *Commissioner*, 138 F. 2d 27, 28 (C.A. 2). Indeed, petitioners do not challenge the constitutionality of these personal holding company provisions upon which the deficiencies were also based.

is subject to the taxpayer's dominion, power or control, the imposition of a tax is permissible and valid. *Griffiths* v. *Commissioner*, 308 U.S. 355, 357-358; *Higgins* v. *Smith*, 308 U.S. 473, 477-478; *Helvering* v. *Clifford*, 309 U.S. 331, 337; *Harrison* v. *Schaffner*, 312 U.S. 579, 580-582. The mere lack of physical receipt does not defeat the power to tax. *United States* v. *Basye, supra; Heiner* v. *Mellon, supra; Helvering* v. *Bruun*, 309 U.S. 461; *Helvering* v. *Horst*, 311 U.S. 112; *Hormel* v. *Helvering*, 312 U.S. 552.

Contrary to petitioner's argument (Pet. 19), the decision below does not conflict with *Eisner* v. *Macomber*, 252 U.S. 189. There, the Court held that it was unconstitutional under the Sixteenth Amendment to require a person to include in income a common stock dividend on common stock. Since such a dividend merely decreased the value of each share of common stock without increasing the interest of the shareholder in the corporation, it did not constitute income. The earnings of Oil Services, however, are income within the meaning of the Sixteenth Amendment, and *Eisner* v. *Macomber, supra*, does not bar the taxation of a corporation's income to a controlling shareholder as in the present case. Moreover, in *Helvering* v. *Bruun, supra*, the Court rejected the proposition that taxable gain could arise only when the taxpayer was able to sever increments from his original capital, which was one of the theoretical bases of *Eisner* v. *Macomber, supra*. See *Helvering* v. *Griffiths*, 318 U.S. 371, 393-394. See

also *Helvering* v. *Horst*, *supra*; *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 430-431; *General American Inv. Co.* v. *Commissioner*, 211 F.2d 522, 523 (C.A. 2), affirmed, 348 U.S. 434.[5]

2. Petitioners further contend (Pet. 13-18) that the decision below is contrary to Section 951(d). They assert that they are relieved from tax on Oil Services' increase in investment of earnings in United States property during the years in which it was also a foreign personal holding company. The provision upon which they rely, Section 951(d), states that a United States shareholder who is subject to tax upon his controlled foreign corporation's earnings pursuant to the foreign personal holding company provisions, "shall not be required to include in gross income, for such taxable year, any amount under [Section 951(a)] with respect to such company."

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[5] *Hoeper* v. *Tax Commission*, 284 U.S. 206, and *Heiner* v. *Donnan*, 285 U.S. 312, cited by petitioner (Pet. 20), have no bearing on the constitutionality of the controlled foreign corporation provisions. In *Hoeper*, the Court struck down a Wisconsin tax statute which assessed a husband for the combined total of his and his wife's income, even though under the law of the state, the husband had no interest in or control over his wife's income. Here, however, petitioners plainly have an interest in and control over the income of Oil Services. In *Donnan*, the Court invalidated a provision of the federal estate tax which created a conclusive presumption that gifts made within two years prior to the death of the donor were made in contemplation of death, requiring their inclusion in his gross estate. But the controlled foreign corporation provisions contain no such conclusive presumption which forecloses any consideration of the underlying facts surrounding a transaction.

As the court of appeals observed (Pet. App. B A53-A54), the purpose of Section 951(d) is readily apparent. Without such a provision, United States shareholders of foreign corporations which qualify as both controlled foreign corporations and foreign personal holding companies would be subject to tax on the same corporate income under Section 551(b), the foreign personal holding company provision, and Section 951(a)(1)(A), the controlled foreign corporation provision. But there is no overlap whatsoever between the amount of foreign personal holding company income to be included in shareholders' gross income and Section 951(a)(1)(B), which taxes the shareholders upon their controlled foreign corporation's increase in earnings invested in United States property. The latter provision applies only with respect to corporate investments made from accumulated earnings. Pursuant to Section 551(e), amounts subject to tax as foreign personal holding company income are subtracted from the corporation's earnings and profits account. Thus, no part of the earnings attributable to foreign personal holding company income could ever be included in its increase in earnings invested in United States property within the meaning of Section 951(a)(1)(B).

We acknowledge that the literal terms of Section 951(d), which speak of relief from tax of "any amount under [Section 951(a)]," could arguably be read in support of petitioner's contention. This Court, however, has recognized that the literal words of a taxing statute must not be applied to defeat the

purpose of Congress. See *Corn Products Co.* v. *Commissioner*, 350 U.S. 46. With respect to the legislative purpose, petitioners offer no suggestion as to why Congress might have wanted to favor foreign personal holding companies by allowing them freely to repatriate previously untaxed earnings in the form of investments in United States property without imposing the adverse tax consequences to which the shareholders of other types of controlled foreign corporations are generally subject. Indeed, in light of the fact that for the past 30 years, Congress has placed foreign personal holding companies in a specially disfavored status because they represented "one of the most flagrant loopholes for tax avoidance" (H. Rep. No. 1546, 75th Cong., 1st Sess., pp. 13-14), it is hardly likely that it would reverse this policy in the enactment of the controlled foreign corporation provisions without a specific reference in the legislative history. However, neither the House nor the Senate Committee report supports the existence of such a broad exemption for the shareholders of foreign personal holding companies. See H. Rep. No. 1447, 87th Cong., 2d Sess., pp. 58-60; S. Rep. No. 1881, 87th Cong., 2d Sess., p. 240.

Finally, the decision below is in accordance with Treasury Regulations, Section 1.951-3, which interprets Section 951(d) in a manner compatible with its purpose to avoid double taxation on the same corporate earnings. That Regulation states that where the undistributed earnings of a controlled foreign corporation are taxable in any year to its sharehold-

ers as foreign personal holding company income, they will not also be taxable under Subpart F as the corporation's earnings and profits for that year. However, the Regulation goes on to provide that corporate earnings of other taxable years in which it was not a foreign personal holding company remain taxable as a quasi-dividend, when invested in "United States property," to the same extent that an actual dividend distribution would be. Treasury Regulations § 1.951-3, Example (5).[6] When considered in the light of the overall purpose of the statute, this Regulation is not unreasonable or plainly inconsistent with the statute. Accordingly, the decision below correctly upheld its validity. See, *e.g.*, *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501; *Bingler* v. *Johnson*, 394 U.S. 741, 749-751; *United States* v. *Correll*, 389 U.S. 299, 306-307.

3. Petitioners' additional argument (Pet. 18-19) that Section 951(a)(1)(B), which taxes them on the increase in investment of Oil Services' earnings in United States property, applies only to post-1962 earnings and profits is without statutory support. They rely on the House version of Subpart F, which did contain such a specific limitation. See H. Rep.

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[6] See also Example (4) of the Regulation which similarly provides that the normal consequences of withdrawing previously excluded "Subpart F income" from qualifying less developed country investment cannot be avoided by qualifying the controlled foreign corporation as a foreign personal holding company. Under petitioners' construction of Section 951(d), such a wholly unwarranted tax benefit would also become available.

No. 1447, 87th Cong., 2d Sess., pp. 63-65. Petitioners fail to point out, however, that the House proposal was drastically changed by the Senate, and the version actually enacted contains no such limitation. The statute does apply only to the investment in United States property acquired after December 31, 1962 (Section 956(b)(1)), but in determining the amount includible under Section 951(a)(1)(B), Section 956(a) specifically provides that the aggregate amount of the controlled foreign corporation's investment in such property is taken into account "to the extent such amount would have constituted a dividend * * * if it had been distributed." Pursuant to Section 316(a) of the Code, the amount which would be taxable as a dividend if distributed includes all earnings and profits accumulated since February 28, 1913. As a result, the decision below correctly concluded (Pet. App. B A56) that Oil Services' retained earnings and profits accumulated prior to 1963 were properly taken into account in determining the amount of its "increase in earnings invested in United States property" for each of the years in question.

4. Finally, petitioners urge (Pet. 20-21) that the deficiency for 1963 was barred by the three-year statute of limitations. The deficiency notice for that year was issued pursuant to the special six-year limitations period provided by Section 6501(e)(1) of the Code in the case of omissions in an amount in excess of 25 percent of gross income. It is undisputed that the "increase in earnings invested in

United States property" by Oil Services that year exceeded 25 percent of the gross income reported on petitioners' return. Petitioners assert that the longer six-year statute is inapplicable under Section 6501 (e)(1)(A)(ii), which provides an exception to the special six-year limitations period where the omitted item is "disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item." The only information supplied by petitioners in this regard was an informational return (Form 2952) with respect to Oil Services. That form disclosed that Oil Services was a controlled foreign corporation and that it had assets of various types. But it did not in any way indicate that any of its assets consisted of any of the various items designated as "United States property" under Section 956(b) nor did it indicate that any of such assets had been acquired by Oil Services in the year 1963 (Pet. App. A A37-A38). Thus, this return did not adequately serve to apprise the Commissioner that there had been an omission of gross income, within the meaning of Section 6501(e)(1)(A)(ii).[7]

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[7] Nothing in *Benderoff* v. *United States*, 398 F. 2d 132, 137 (C.A. 8) (Pet. 21), is to the contrary. While the Eighth Circuit in that case spoke in terms of providing a "clue as to the omitted income," the fact of the omission, as well as its nature and amount, would have been apparent by an analysis of the returns filed by the taxpayers and their Subchapter S corporation. Nor did this Court in *Colony, Inc.* v. *Commissioner*, 357 U.S. 28 (Pet. 21), purport to establish a "clue" test less stringent than that specifically adopted by Congress

The mere fact that petitioners disclosed the existence of their controlled foreign corporation did not serve to put the Commissioner on notice that they had omitted any amount with respect to its earnings.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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SEPTEMBER 1974.

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in Section 6501(e). See also *Cardinal Life Insurance Co.* v. *United States*, 425 F.2d 1328 (C.A. 5).

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of the earnings and profits accumlated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

* * * *

SEC. 551. FOREIGN PERSONAL HOLDING COMPANY INCOME TAXED TO UNITED STATES SHAREHOLDERS.

(a) *General Rule.*—The undistributed foreign personal holding company income of a foreign

personal holding company shall be included in the gross income of the citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts (other than estates or trusts the gross income of which under this subtitle includes only income from sources within the United States), who are shareholders in such foreign personal holding company (hereinafter called "United States shareholders") in the manner and to the extent set forth in this part.

(b) [as amended by Sec. 225(f)(4), Revenue Act of 1964, P.L. 88-272, 78 Stat. 19, 88] [18] *Amount Included in Gross Income.*—Each United States shareholder, who was a shareholder on the day in the taxable year of the company which was the last day on which a United States group (as defined in section 552(a)(2)) existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends, the amount he would have received as a dividend (determined as if any distribution in liquidation actually made in such taxable year had not been made) if on such last day there had been distributed by the company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the company for the tax-

[18] This amendment, which added the parenthetical language "(determined as if any distribution in liquidation actually made in such taxable year had not been made)," is applicable to distributions made in any taxable year of the distributing corporation beginning after December 31, 1963. The amendment does not affect the issues in this case.

able year as the portion of such taxable year up to and including such last day bears to the entire taxable year.

* * * *

(e) *Effect on Capital Account of Foreign Personal Holding Company.*—An amount which bears the same ratio to the undistributed foreign personal holding company income of the foreign personal holding company for its taxable year as the portion of such taxable year up to and including the last day on which a United States group existed with respect to the company bears to the entire taxable year, shall, for the purpose of determining the effect of distributions in subsequent taxable years by the corporation, be considered as paid-in surplus or as a contribution to capital, and the accumulated earnings and profits as of the close of the taxable year shall be correspondingly reduced, if such amount or any portion thereof is required to be included as a dividend, directly or indirectly, in the gross income of United States shareholders.

* * * *

SEC. 951 [as added by Sec. 12(a), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960, 1006]. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS.

(a) *Amounts Included.*—

(1) *In general.*—If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year beginning after

December 31, 1962, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958 (a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends—

(A) the sum of—

(i) except as provided in section 963, his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year, and

(ii) his pro rata share (determined under section 955(a)(3)) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year; and

(B) his pro rata share (determined under section 956(a)(2)) of the corporation's increase in earnings invested in United States property for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

* * * *

(b) *United States Shareholder Defined.*—For purposes of this subpart, the term "United States shareholder" means, with respect to any foreign corporation, a United States person (as defined in section 957(d)) who owns (within the mean-

ing of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

* * * *

(d) *Coordination with Foreign Personal Holding Company Provisions.*—A United States shareholder who, for his taxable year, is subject to tax under section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholders) on income of a controlled foreign corporation shall not be required to include in gross income, for such taxable year, any amount under subsection (a) with respect to such company.

SEC. 952 [as added by Sec. 12(a), Revenue Act of 1962, *supra*]. SUBPART F INCOME DEFINED.

(a) *In General.*—For purposes of this subpart, the term "subpart F income" means, in the case of any controlled foreign corporation, the sum of—

(1) the income derived from the insurance of United States risks (as determined under section 953), and

(2) the foreign base company income (as determined under section 954).

* * * *

SEC. 954 [as added by Sec. 12(a), Revenue Act of 1962, *supra*]. FOREIGN BASE COMPANY INCOME.

(a) *Foreign Base Company Income.*—For purposes of section 952(a)(2), the term "foreign base company income" means for any taxable year the sum of—

(1) the foreign personal holding company income for the taxable year (determined under subsection (c) and reduced as provided in subsection (b)(5)),

(2) the foreign base company sales income for the taxable year (determined under subsection (d) and reduced as provided in subsection (b)(5)), and

(3) the foreign base company services income for the taxable year (determined under subsection (e) and reduced as provided in subsection (b)(5)).

* * * *

(c) *Foreign Personal Holding Company Income—*

(1) *In general.*—For purposes of subsection (a)(1), the term "foreign personal holding company income" means the foreign personal holding company income (as defined in section 553), modified and adjusted as provided in paragraphs (2), (3), and (4).

* * * *

SEC. 956. [as added by Sec. 12(a), Revenue Act of 1962, *supra*]. INVESTMENT OF EARNINGS IN UNITED STATES PROPERTY.

(a) *General Rules.*—For purposes of this subpart—

(1) *Amount of investment.*—The amount of earnings of a controlled foreign corporation invested in United States property at the close of any taxable year is the aggregate amount of such property held, directly or indirectly, by the controlled foreign corporation at the close of the taxable year, to the extent such amount would have constituted a dividend (determined after the application of section 955(a)) if it had been distributed.

(2) *Pro rata share of increase for year.*—In the case of any United States shareholder, the pro rata share of the increase for any taxable year in the earnings of a controlled foreign corporation invested in United States property is the amount determined by subtracting his pro rata share of—

(A) the amount determined under paragraph (1) for the close of the preceding taxable year, reduced by amounts paid during such preceding taxable year to which section 959(c)(1) applies, from

(B) the amount determined under paragraph (1) for the close of the taxable year.

The determinations under subparagraph (A) and (B) shall be made on the basis of stock owned (within the meaning of section 958(a)) by such United States shareholder on the last day during the taxable year on which the foreign corporation is a controlled foreign corporation.

(3) *Amount attributable to property.*—The amount taken into account under paragraph (1) or (2) with respect to any property shall be its adjusted basis, reduced by any liability to which the property is subject.

(b) *United States Property Defined.*—

(1) *In general.*—For purposes of subsection (a), the term "United States property" means any property acquired after December 31, 1962, which is—

(A) tangible property located in the United States;

(B) stock of a domestic corporation;

(C) an obligation of a United States person; or

(D) any right to the use in the United States of—

(i) a patent or copyright,

(ii) an invention, model or design (whether or not patented),

(iii) a secret formula or process, or

(iv) any other similar property right,

which is acquired or developed by the controlled foreign corporation for use in the United States.

(2) *Exceptions.*—For purposes of subsection (a), the term "United States property" does not include—

(A) obligations of the United States, money, or deposits with persons carrying on the banking business;

(B) property located in the United States which is purchased in the United States for export to, or use in, foreign countries;

(C) any obligation of a United States person arising in connection with the sale or processing of property if the amount of such obligation outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person had the sale or processing transaction been made between unrelated persons;

(D) any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States;

(E) an amount of assets of an insurance company equivalent to the unearned premiums or reserves ordinary and necessary for the proper conduct of

its insurance business attributable to contracts which are not contracts described in section 953(a)(1); and

(F) an amount of assets of the controlled foreign corporation equal to the earnings and profits accumulated after December 31, 1962, and excluded from subpart F income under section 952(b).

* * * *

SEC. 957 [as added by Sec. 12(a), Revenue Act of 1962, *supra*]. CONTROLLED FOREIGN CORPORATIONS; UNITED STATES PERSONS.

(a) *General Rule.*—For purposes of this subpart, the term "controlled foreign corporation" means any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.

* * * *

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

* * * *

(e) [as amended by Sec. 810(b)(2), Excise Tax Reduction Act of 1965, P.L. 89-44, 79 Stat. 136, 169] *Substantial Omission of Items.*—Except as otherwise provided in subsection (c)—

(1) *Income taxes.*—In the case of any tax imposed by subtitle A—

(A) *General rule.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph—

(i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services;

(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item.

(B) *Constructive dividends.*—If the taxpayer omits from gross income an amount properly includible therein under section 551(b) (relating to the inclusion in the gross income of United

States shareholders of their distributive shares of the undistributed foreign personal holding company income), the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.

* * * *

Treasury Regulation on Income Tax (1954 Code) (26 C.F.R.):

§ *1.951-3 Coordination of subpart F with foreign personal holding company provisions.*

A United States shareholder (as defined in section 951(b)) who is required under section 551(b) to include in his gross income for his taxable year his share of the undistributed foreign personal holding company income for the taxable year of a foreign personal holding company (as defined in section 552) which for that taxable year is a controlled foreign corporation (as defined in section 957) shall not be required to include in his gross income for his taxable year under section 951(a) and paragraph (a) of § 1.951-1 any amount attributable to the earnings and profits of such corporation for that taxable year of such corporation. If a foreign corporation is both a foreign personal holding company and a controlled foreign corporation for the same period which is only a part of its taxable year, then, for purposes of applying the immediately preceding sentence, such corporation shall be deemed to be, for such part of such year, a

foreign personal holding company and not a controlled foreign corporation and the earnings and profits of such corporation for the taxable year shall be deemed to be that amount which bears the same ratio to its earnings and profits for the taxable year as such part of the taxable year bears to the entire taxable year. The application of this section may be illustrated by the following examples:

* * * *

Example (4). (a) A, a United States shareholder, owns 100 percent of the only class of stock of controlled foreign corporation P, organized on January 1, 1963. Both A and P Corporation use the calendar year as a taxable year. During 1963, 1964, and 1965, P Corporation is not a foreign personal holding company as defined in section 552(a); in each of such years, P Corporation derives dividend income of $10,000 which constitutes foreign personal holding company income (within the meaning of § 1.954-2) but under paragraph (b)(1) of § 1.954-1 excludes such amounts from foreign base company income as dividends received from, and reinvested in, qualified investments in less developed countries. Corporation P's earnings and profits accumulated for 1963, 1964, and 1965 and determined under paragraph (b)(2) of § 1.955-1 are $40,000. For 1966, P Corporation is a foreign personal holding company, has predistribution earnings and profits of $10,000, derives $10,000 of income which is both foreign personal holding company income within the meaning of section 553 and subpart F income within the meaning of section 952, distributes $8,000 to A, and has undistributed foreign personal holding company in-

come of $2,000 within the meaning of section 556. In addition, for 1966 P Corporation has a withdrawal (determined under section 955(a) but without regard to its earning and profits for such year) of $25,000 of previously excluded subpart F income from investment in less developed countries. A is required under section 551(b) to include in his gross income for 1966 as a dividend the $2,000 undistributed foreign personal holding company income. The $8,000 distribution is includible in A's gross income for 1966 under sections 61(a)(7) and 301 as a distribution to which section 316(a)(2) applies. Corporation P's $25,000 withdrawal of previously excluded subpart F income from investment in less developed countries is includible in A's gross income for 1966 under section 951(a)(1)(A)(ii) and paragraph (a)(2) of § 1.951-1.

(b) If P Corporation's earnings and profits accumulated for 1963, 1964, and 1965 were $15,000, instead of $40,000, the result would be the same as in paragraph (a) of this example, except that a withdrawal of only $15,000 of previously excluded subpart F income from investment in less developed countries would be includible in A's gross income for 1966 under section 951(a)(1)(A)(ii) and paragraph (a)(2) of § 1.951-1.

Example (5). (a) The facts are the same as in paragraph (a) of example (4), except that, instead of having a $25,000 decrease in qualified investments in less developed countries for 1966, P Corporation invests $20,000 in tangible property (not described in section 956(b)(2)) located in the United States and such investment constitutes an increase (determined under section 956

(a) but without regard to the earnings and profits of P Corporation for 1966) in earnings invested in United States property. Corporation P's earnings and profits accumulated for 1963, 1964, and 1965 and determined under paragraph (b)(1) of § 1.956-1 are $22,000. The result is the same as in paragraph (a) of example (4), except that instead of including the $25,000 withdrawal, A must include $20,000 in his gross income for 1966 under section 951(a)(1)(B) and paragraph (a)(3) of § 1.951-1 as an investment of earnings in United States property.

(b) If P Corporation's earnings and profits accumulated for 1963, 1964, and 1965 were $9,000 instead of $22,000, the result would be the same as in paragraph (a) of this example, except that only $9,000 would be includible in A's gross income for 1966 under section 951(a)(1)(B) and paragraph (a)(3) of § 1.951-1 as an investment of earnings in United States property.

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